Bond Market Update

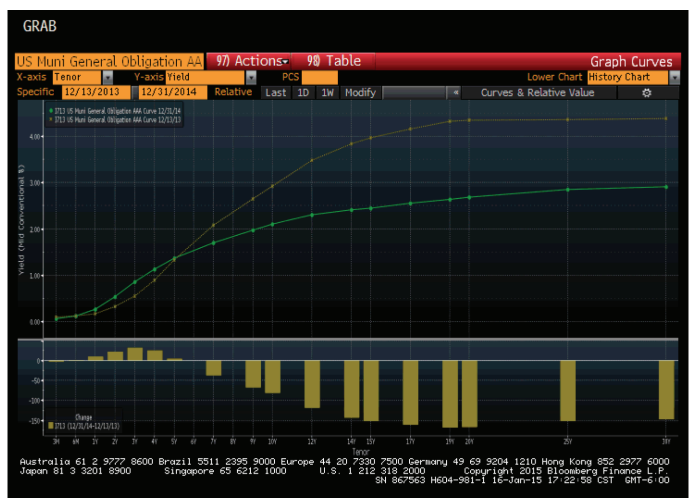
As of December 31, 2014 / Volume 3, Issue 4 / FFTAM.COM

As 2015 begins, a look back over 2014 can provide some helpful insights as to what happened during the prior year, but moreover, be useful with setting expectations for the upcoming year.

The bond markets generally performed better than our expectations and dramatically better than the consensus of the Street. The Barclays Aggregate Bond Index (a very broad bond market index) recorded a total return of 5.97% and the Barclays 1-10 year Municipal Bond Blended Index recorded 4.65%. These returns are remarkable given the fact that most Wall Street economists predicted that interest rates were most likely to rise throughout the year. Just as a reminder, our position is that predicting interest rate levels in isolation does not work. We pursue a strategy of identifying attractive risk-to-return profiles within the context of a slight interest rate bias. During 2014, we had a slight bias toward lower interest rates within the context of very high credit quality which tended to generate superior risk-adjusted total returns.

From an economic standpoint, the US economy in 2014 performed relatively well. While GDP contracted -2.1% in the 1st quarter of 2014, 2nd and 3rd quarter GDP numbers were 4.6% and 5.0%, respectively. The projections for the 4th quarter of 2014 are for growth of 3.2%. ISM Manufacturing and ISM Nonmanufacturing continued to record readings steadily above 50 throughout the year (a reading above 50 is viewed positively by the market). Consumer confidence made a steady climb, while on the other hand, jobless claims continued their steady decline. For 2014, the unemployment rate finished the year at 5.60%. Taken together, a positive year for the US economy.

Below to the left is the US Treasury curve as of 12/31/13 and 12/31/14. As you will see, the yield curve flattened downward with the pivot around the 5-year part of the curve. Shorter maturity rates rose slightly as market expectations that the Federal Reserve would come into play increased throughout the year. Longer dated rates fell for several reasons enumerated below the charts.



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The AAA Municipal Yield curve as of 12/31/13 and 12/31/14 is to the right. Its results are very similar to the US Treasury curve to the left.

As with both curves, the longer dated yields ignored the better than expected growth here in the US and instead focused on other factors. Europe continued to experience very anemic to no growth, Japan falling back into recession, China slowing with its real estate market weaknesses beginning to show, the US rate market offering very competitive absolute rates relative to other developed countries, the strong US Dollar, and the collapse of commodity prices. The collapse of oil prices was the final straw and started a flight to quality bid in the market. US Treasury's and AAA Muni Bonds benefited with investors seeking quality and safety.
For the year, a comparison of how investment grade credits performed relative to high yield credits reveals a substantial outperformance by investment grade. This is due to investment grade credits experiencing a slight widening of 20bps in yield versus risk free rates, whereas, high yield bonds experienced a significant widening of 120bps versus risk free rates (much of this change occurring in the 4th quarter with the collapse of oil). This relationship provides some evidence that bond investors are becoming more risk averse as the global economic landscape becomes more uncertain.

Looking forward into 2015, we will continue to deploy the same strategy as 2014. In short, we remain committed to a very high credit quality portfolio with a slight bias towards lower interest rates. With growth around the world being subdued and credit markets showing signs of weakness, it is important to stay conservative while maintaining the ability to take advantage of attractive situations if and when they arise. With the drop in price of oil and the speed with which it happened, it is our expectation, at the present time, that the Federal Reserve will not raise interest rates.

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